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In the Supreme Court of the United States

OCTOBER TERM, 1993

CONTINENTAL ILLINOIS CORPORATION, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, contrary to this Court's decision in *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), the court of appeals correctly held that a taxpayer must report funds as income upon receipt even though the taxpayer is contractually obligated to repay those funds unless contingencies occur that are outside of the taxpayer's control.

RULE 29.1 STATEMENT

Pursuant to Rule 29.1 of the Rules of this Court, the subsidiaries (other than wholly-owned subsidiaries) of petitioner Continental Illinois Corporation (now known as Continental Bank Corporation) are as follows:

Ametech, Inc.

Celutel, Inc.

Q Media Holding

Plastic Engineered Components, Inc.

Intercraft Holdings, L.P.

Humphreys Inc.

Home Technology Healthcare, Inc.

LNS Group, Inc.

SNMC Management Corp. — Sunbelt National Mortgage Corp.

Continental Investment Corporation, S.A. (Argentina)

Continental Information & Technology Services Co., S.A. (Argentina)

CIC Trading, S.A. (Argentina)

Continental Banco, S.A. (Brazil)

Justin, Inc. (Chile)

Labco 1 Inc., Chile Limitada (Chile)

Petitioner does not have a parent company.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Continental Illinois Corporation respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-15a) is reported at 998 F.2d 513. The opinion of the Tax Court (App., *infra*, 16a-48a) is unofficially reported at 58 T.C.M. (CCH) 790.

JURISDICTION

The judgment of the court of appeals was entered on July 9, 1993, and this petition is being filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT

This case presents a federal tax issue of substantial importance: whether a taxpayer must report as "income" within the meaning of Section 61(a) of the Internal Revenue Code the receipt of funds that it is obligated to repay unless contingencies occur that lie wholly outside its control. The Seventh Circuit held that a taxpayer must report such receipts as income. In so doing, the court of appeals disregarded a long line of decisions of this Court establishing that a receipt is not income if the taxpayer lacks "complete dominion" over the funds. In particular, it failed to apply the principles set forth in *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203, 210 (1990), which make clear that a taxpayer does not have "complete dominion" over funds unless it has a guarantee of being able to retain the money. Misinterpreting *Indianapolis Power* as concerned only with the tax treatment of a narrow range of security deposits, the Seventh Circuit reached a decision squarely in conflict with *Ware* v. *Commissioner*, 906 F.2d 62 (2d Cir. 1990), which properly treated *Indianapolis Power* as the source of generally applicable standards for identification of income. The court of appeals' decision in this case has thus created substantial confusion over the scope of *Indianapolis Power*, and hence uncertainty about the proper definition of the fundamental concept of "income" under the federal tax code.

1. Continental's CAP Loans

Petitioner Continental Illinois Corporation (now known as Continental Bank Corporation) is the parent company of Continental Illinois National Bank and Trust Company of Chicago ("Continental" or "the bank") (now known as Continental Bank N.A.). The parent and subsidiary file consolidated federal income tax returns. The Internal Revenue Service assessed deficiencies against petitioner for

the years 1977, 1978, and 1979, on the ground that it had failed to report as income certain "excess interest" that Continental received from borrowers who had outstanding "CAP loans."

CAP loans are a type of loan that Continental has offered to creditworthy business customers. During the tax years at issue in this case, the bank had 61 CAP loans outstanding, either as sole lender or as one of a number of banks participating in a loan. CAP loans typically were made for a term of from five to ten years. App., *infra*, 13a, 19a.

Continental's CAP loan agreement provided for two different interest rates. First, it specified that the borrower was to make periodic interest payments at a floating interest rate computed at a percentage above Continental's prime rate (the interest rate that the bank offered for 90-day unsecured loans to its best corporate customers). Continental's prime rate, and hence the floating interest rate customers paid for CAP loans, changed frequently, ranging from a low of 4.75 per cent in 1972 to a high of 21.5 per cent in 1980. App., *infra*, 13a, 19a-20a; CEx. 8-H.[1] The CAP loan agreement also specified a second rate of interest, known as the CAP rate. Unlike the floating rate, the CAP rate was a fixed interest rate (*e.g.*, 8 per cent) that generally remained constant over the life of the loan. It was commonly set at 1-1/2 to 2 percentage points over the prime rate in use at the time the loan was made. App., *infra*, 20a.

CAP loans differed from conventional loans in that Continental agreed to refund to the borrower at maturity any

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[1] "CEx. __" refers to exhibits in the Tax Court record on the CAP loans issue. "Doc. No. __" refers to documents in the record on appeal as designated by the Clerk of the Tax Court.

amount by which the interest actually paid over the life of the loan using the floating rate exceeded the interest that would have been paid over the life of the loan using the CAP rate. This sum was referred to as "excess interest." There were only two exceptions to Continental's obligation to refund excess interest to a borrower: it was entitled to keep excess interest if the customer defaulted on the loan or prepaid the loan before the date of maturity. App., *infra*, 20a-22a.

Prior to refunding excess interest (or becoming entitled to keep it as a result of customer default or prepayment), Continental held excess interest in a liability or reserve account for "interest collected but not earned." Monies in this account were part of the bank's general funds and were available for investment or other purposes, subject to financial and regulatory requirements that Continental maintain sufficient assets to discharge its liabilities. Continental did not pay its borrowers interest on excess interest. App., *infra*, 20a-21a.

During the tax years at issue, the floating rate on CAP loans was almost always higher than the CAP rate. In consequence, Continental collected significant amounts of excess interest. In accordance with its loan agreement, Continental refunded a large proportion of this excess interest to borrowers when their loans matured. App., *infra*, 23a-24a; Doc. No. 63, ¶¶ 34-41.

2. The IRS's Deficiency Assessment

The IRS assessed an income tax deficiency against Continental of over $26 million for 1977 to 1979 because it did not agree with Continental's method of reporting excess interest. App., *infra*, 24a-25a. Continental accounted for interest paid by CAP loan borrowers in the same way for

financial, regulatory, and federal income tax purposes. Doc. No. 63, ¶ 20. For each interest period, the bank compared the amount of interest due on the outstanding balance of the loan using the floating rate and using the CAP rate. From this comparison, Continental det rmined whether the customer's payment of interest at the floating rate had resulted in payment of excess interest because the floating rate was above the CAP rate, or in an "interest shortfall" because the CAP rate exceeded the floating rate. App., *infra*, 20a.

When the floating rate was more than the CAP rate for an interest period, Continental accrued and reported as income that part of the interest received that would have been payable under the CAP rate, because it received that money without any obligation to make a refund to the borrower upon termination of the loan. Continental did not report as income that portion of the payment that was "excess interest" subject to the bank's contractual repayment obligation. App., *infra*, 20a-21a, 24a.

When the floating rate was less than the CAP rate, creating an interest shortfall, Continental accrued as income the amount of interest paid at the floating rate plus any excess interest previously paid by the borrower that was available to cover the shortfall. It simultaneously reduced the balance in the "interest collected but not earned" account by the amount of excess interest used to reduce the shortfall. App., *infra*, 21a. Because the floating rate was high throughout the tax years at issue, however, Continental rarely took excess interest into income to cover an interest shortfall; fully 89 per cent of debits to the unearned interest account represented repayments of excess interest to customers upon termination of a loan. Doc. No. 63, ¶¶ 39, 41.

In addition, the CAP loan agreement provided that Continental's obligation to repay excess interest ceased if a customer defaulted on or prepaid its loan. Continental therefore reported as income any excess interest forfeited by a customer upon default or prepayment of a CAP loan. Doc. No. 63, ¶ 32.

According to the IRS's deficiency notice, this method of accounting for and reporting excess interest did not properly reflect Continental's income. The IRS instead assessed taxes against Continental on the theory that the bank had accrued income in the full amount of interest at the floating rate when it received that interest — even though Continental was required to refund most of this amount pursuant to the express terms of its loan agreements. App., *infra*, 24a-25a.

3. Proceedings in the Tax Court

Continental challenged the IRS's deficiency determination. The bank contended that excess interest was not income because Continental received it subject to a contractual obligation to repay excess interest at the termination of the CAP loan. Continental's refund obligation was contingent solely on market factors and borrower decisions over which it lacked any control.

The Tax Court disagreed. Ruling before this Court decided *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), the Tax Court held that excess interest paid by CAP loan borrowers constituted income to Continental at the time of receipt. The Tax Court recognized that Continental's ability to retain excess interest was ephemeral because its "repayment obligation depended upon interest rate volatility and whims of CAP Loan borrowers." App., *infra*, 45a-46a. It acknowledged as well that Continental's "actual experience" showed that there was a "high probability" that

the bank would be required to refund excess interest to borrowers. *Id.* at 41a. Nevertheless, the court held that all excess interest should be treated as income.

According to the Tax Court, the "relevant inquiry" was "whether [Continental's] repayment obligation [was] unequivocal," in which case excess interest would not constitute income, or was "contingent," in which case the IRS properly treated excess interest as income upon receipt. Here, the court concluded, "there was no certainty as to the repayment of excess interest to CAP Loan borrowers" (App., *infra*, 41a), and "[t]he mere fact that the excess interest received by [Continental] may have to be returned at a later date did not deprive such excess interest of its character as taxable income when received." *Id.* at 33a-34a. The Tax Court denied without comment petitioner's motion to reconsider its decision after this Court held in *Indianapolis Power* that a customer deposit, which the taxpayer was under a contractual obligation to refund, did not constitute income upon receipt.

4. The Seventh Circuit's Decision

The Seventh Circuit affirmed. Without any discussion of the standards set forth in *Indianapolis Power*, the court of appeals perfunctorily dismissed that case as relevant solely to the question whether a customer deposit is income. App., *infra*, 14a. The excess interest paid to Continental by CAP loan borrowers, the court reasoned, was not comparable to a customer deposit.

Having thus put to one side the specific legal standards set forth in *Indianapolis Power* for determining whether customer payments constitute income, the court of appeals concluded that, in the absence of clear rules, "much * * * must be left to the Internal Revenue Service's discretion." App., *infra*, 15a. The court then sought to justify the IRS's

deficiency determination by reference to general analogies unsupported by citation to any legal authority. According to the Seventh Circuit, Continental's agreement to refund excess interest was comparable to "a seller's promise to rebate a portion of the purchase price if the customer establishes that he could have bought the same good from another seller at a lower price." *Ibid.* This sort of money-back guarantee, the court reasoned, is, in turn, akin to a seller's warranty to refund the purchase price of defective goods. And a warranty against defective products "reduce[s] the certainty of the seller's income stream but do[es] not convert income into the equivalent of a deposit or a bailment." *Ibid.* Contingencies of this sort, the court concluded, "have never been thought to entitle a seller to delay recognizing income until the time during which the contingencies could have materialized is past." *Id.* at 14a.

REASONS FOR GRANTING THE PETITION

Three years ago, in *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990), this Court unanimously held that a taxpayer's receipt of money does not constitute "income," within the meaning of Section 61(a) of the Internal Revenue Code, if the taxpayer lacks "complete dominion" over the funds. It also held that "[i]n determining whether a taxpayer enjoys 'complete dominion' over a given sum, the crucial point is not whether his use of the funds is unconstrained during some interim period. *The key is whether the taxpayer has some guarantee that he will be allowed to keep the money.*" *Id.* at 210 (emphasis added).

As applied here, the test announced in *Indianapolis Power* plainly demonstrates that the excess interest Continental received under the CAP loan program was not income in the year of receipt. Continental did not exercise "complete dominion" over the funds, because it had no guarantee that

it would be allowed to keep the money. To the contrary, Continental was contractually bound to repay the excess interest under specified circumstances, which depended upon borrower behavior and market factors over which it lacked any control. Moreover, the Tax Court acknowledged that there was a "high probability" that Continental would have to refund the excess interest to its borrowers under the CAP loan program (App., *infra*, 41a), and Continental in fact repaid virtually all of the excess interest it had received during the tax years in question.

Even though this Court in *Indianapolis Power* made clear that its opinion addressed the legal standard for "determining what sort of economic benefits qualify as income" (493 U.S. at 208-209), the Seventh Circuit sought to distinguish *Indianapolis Power* as a case that addressed only the narrow question whether a security deposit is taxable income. The court of appeals' cramped reading of *Indianapolis Power* is manifestly incorrect. It is also squarely inconsistent with the Second Circuit's recognition in *Ware* v. *Commissioner*, 906 F.2d 62 (2d Cir. 1990), that *Indianapolis Power* sets out generally applicable principles for the identification of income.

The Seventh Circuit's erroneous interpretation of *Indianapolis Power* creates substantial confusion about the tax treatment of a broad variety of ordinary commercial transactions that involve the receipt of funds subject to a contractual obligation to make repayment; and its endorsement of the Internal Revenue Service's expansive view of what receipts constitute income imposes a significant and unjustified economic burden on businesses throughout the nation. Further review is warranted to return the IRS and the courts to the principles of income-identification that were delineated in *Indianapolis Power*.

I. THE SEVENTH CIRCUIT'S DECISION CONFLICTS WITH THIS COURT'S RULING IN *INDIANAPOLIS POWER*

In *Commissioner* v. *Indianapolis Power & Light Co.* this Court laid down precise legal standards for the definition of income that were simply ignored by the court of appeals in this case. The question in *Indianapolis Power* was whether a utility company ("IPL") accrued taxable income when it required certain customers to pay deposits in twice the amount of their estimated monthly electricity costs "to insure prompt payment" of their future bills. 493 U.S. at 204. IPL lacked any assurance that it could retain customer deposits as payments for future services. Rather, it had a contractual obligation to refund a deposit when the customer established good credit or terminated service, and any deposit that remained unclaimed eventually escheated to the state. *Id.* at 204-205. Only "if the customer default[ed] or [if a customer who otherwise would be entitled to the return of his deposit requested that IPL] apply his refund to a future bill" could IPL set deposits off against charges for electricity. *Id.* at 211 n.7.

In these circumstances, this Court held, customer deposits did *not* constitute income to IPL. The "crucial point" in determining whether a receipt of funds is income, the Court explained, "is whether the taxpayer has some guarantee that he will be allowed to keep the money." 493 U.S. at 210. It is this "guarantee" that provides the distinction between a taxable receipt like an advance payment, where the payor "retains no right to insist upon the return of the funds" if "the recipient fulfills the terms of the bargain" (*id.* at 212), and a nontaxable receipt like a deposit, where "both the timing and method of * * * refund are largely within the control of the customer." *Id.* at 209.

"[A]t the time the payments [were] made," IPL plainly had no guarantee that it would be able to keep the funds. 493 U.S. at 211 (emphasis omitted). On the contrary, it received the deposits "subject to an express 'obligation to repay'" them except under circumstances that were "largely within the control of the customer." *Id.* at 209, quoting *James* v. *United States*, 366 U.S. 213, 219 (1961). Thus, the Court concluded, IPL's dominion over the deposits was "insufficient for the[m] to qualify as taxable income at the time they [were] made." 493 U.S. at 214.

Indianapolis Power thus prescribes specific legal standards for determining whether a receipt qualifies as "income" under section 61(a) of the Internal Revenue Code, 26 U.S.C. § 61(a). See App., *infra*, 49a. "[P]ayments constitute income when received" only if it appears, upon examining "the parties' rights and obligations at the time the payments are made," that the taxpayer has "'complete dominion'" over the payments such that it has "some guarantee" that it may keep the money. 493 U.S. at 210, 211. The existence of a speculative right to retain the money that is "contingent upon events outside [the taxpayer's] control" does not make the receipt of money a taxable event. *Id.* at 214.

It is impossible to reconcile these unambiguous standards for identification of income with the Seventh Circuit's holding that Continental must report the receipt of excess interest on CAP loans as income. Like the utility in *Indianapolis Power*, Continental indisputably lacked "unfettered 'dominion' over the money at the time of receipt"; it had no "guarantee" whatsoever that it would be able to keep any excess interest. 493 U.S. at 210, 212. The bank's receipt of interest on CAP loans was subject to an express contractual obligation to refund the amount by which interest paid

using the floating rate formula exceeded the amount that would have been paid if interest had been calculated using the CAP rate. See pages 3-4, *supra*. Accordingly, "at the time the payments [were] made," Continental had an "express 'obligation to repay'" excess interest at the expiration of the loan term. 493 U.S. at 209, 211. And in fact it did so here. App., *infra*, 13a-14a, 32a-33a.

Moreover, Continental's obligation to refund excess interest was "contingent [solely] upon events outside its control." 493 U.S. at 214. Because the floating rate that determined a borrower's payments was tied to market interest rates, whether the bank held excess interest at all depended upon money market conditions over which it had no command. If Continental did hold excess interest on a loan — as was usually the case during the tax years in issue, when the CAP loan's floating rate was consistently high — it was obliged to refund that money unless the borrower either defaulted on the loan or prepaid its principal. See pages 3-4, *supra*.

It follows that the "complete dominion" test set out in *Indianapolis Power* denies the IRS the power to treat excess interest as income to Continental upon receipt. That conclusion is not cast in doubt either because Continental had "use of [excess interest for its own benefit] during some interim period" pending determination whether the funds would be kept or repaid (493 U.S. at 210), or because the bank did not pay CAP loan borrowers interest on excess interest. In *Indianapolis Power* itself, the taxpayer commingled deposits with other funds, paid no interest on deposits held for less than 12 months and below-market interest for deposits held longer, and derived a clear "economic benefit" from "unrestricted use of the money." *Id.* at 205, 208-210.

In rejecting the Commissioner's argument that these factors showed customer deposits to be income, this Court drew an analogy to commercial loans that is fully applicable to the facts of this case. A commercial loan, the Court pointed out, "confers an economic benefit on the recipient" because a business borrows only if it expects to realize benefits from a loan beyond the cost of servicing the debt. 493 U.S. at 208. Nevertheless, it is well-established that "'[b]ecause of [the repayment] obligation, * * * loan proceeds do not qualify as income to the [borrower].'" *Id.* at 207-208, quoting *Commissioner* v. *Tufts*, 461 U.S. 300, 307 (1983). The Court concluded that although income earned through use of money over which the recipient lacks complete dominion is taxable, the mere "prospect that income will be generated provides no ground for taxing the principal." 493 U.S. at 210. Thus, the fact that Continental may have derived some benefit from the use of excess interest in no way converted that interest into taxable income.

Indianapolis Power is controlling here. The Seventh Circuit's decision to the contrary rested upon its view that the principles enunciated in *Indianapolis Power* apply only to customer deposits, narrowly conceived. App., *infra*, 14a-15a. That restrictive interpretation is untenable in light of the general terms in which this Court stated the "complete dominion" test in *Indianapolis Power*. As the Solicitor General acknowledged in his petition for certiorari in *Indianapolis Power*, the principles involved in that case "have ramifications * * * outside the public utility context." Petition for Certiorari at 8, *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990) (No. 88-1319). Furthermore, the Seventh Circuit's narrow reading of *Indianapolis Power* is wholly incompatible with this Court's derivation of the "complete dominion" test from precedents that involved payments far removed from customer deposits.

493 U.S. at 209, citing *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (antitrust treble damages), and *James*, 366 U.S. at 219 (embezzled funds); see pages 15-16, *infra*.

The court of appeals' strained effort to draw a line between excess interest and the customer deposits at issue in *Indianapolis Power* is in any event wholly unconvincing. The Seventh Circuit acknowledged that at the time Continental received excess interest, the likelihood that it would "have to repay much or even all [those funds to] customers [was] substantial," and that the bank in fact returned most excess interest to borrowers. App., *infra*, 14a, 15a. Nevertheless, the court purported to discern a relevant difference between excess interest and a deposit because Continental did not "merely hol[d] the money that [it] receive[d] in the account of the [CAP loan borrower] as if it were a deposit." *Id.* at 15a. As this Court made clear, however, the utility in *Indianapolis Power* did *not* merely hold deposits in customer accounts. Instead, it used the money as its own while maintaining the deposit as a bookkeeping entry pending determination whether the deposit was to be refunded or used to pay for electricity service. 493 U.S. at 205, 208-209. In all essential respects, then, Continental's treatment of excess interest was identical to IPL's handling of customer deposits. See pages 4-6, *supra*.

Nor has the Seventh Circuit's limitation of the income-identification principles set out in *Indianapolis Power* been accepted by other courts of appeals. In *Ware* v. *Commissioner*, 906 F.2d 62 (2d Cir. 1990), the court considered whether a fee charged by a law firm, but paid into and held in escrow during 1981 because of a dispute with the client, was properly includable in the firm's partnership income for 1981. The Second Circuit applied *Indianapolis Power's*

"complete dominion" test. It held that because the fee was escrowed, the law firm "had no * * * guarantee" that it would be able to keep the money and that "[t]he fee therefore was not properly includible in the firm's 1981 return, even if the firm filed its 1981 taxes on an accrual basis." *Id.* at 65. *Ware* properly treats the test for income in *Indianapolis Power* as one of general application, rather than as limited to customer deposits, and is inconsistent with the Seventh Circuit's decision in this case.

This Court's review is thus necessary to uphold the legal standards prescribed in *Indianapolis Power* and to settle the conflict with the Second Circuit's ruling in *Ware*.

II. THE COMPLETE DOMINION TEST IS NOT LIMITED TO CUSTOMER DEPOSITS

Indianapolis Power is the most recent iteration of the long-standing definition of "income" as receipts over which the taxpayer has "complete dominion." The "complete dominion" standard was first enunciated in *Glenshaw Glass*, 348 U.S. at 431, where this Court defined income to include all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Subsequently, in *James*, 366 U.S. at 219, the Court made clear that this standard was a general legal test used to *define* taxable income.[2]

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[2] By contrast, the "claim of right" doctrine derived from *North American Oil Consol.* v. *Burnet*, 286 U.S. 417, 424 (1932), relied on by the government in the Seventh Circuit (Br. at 68-70), concerns not the definition but the *timing* of income recognition. See *James*, 366 U.S. at 216 n.7 (the Solicitor General conceded that "the claim of right test was a doctrine invoked by the Court * * * to determine *when*, not *whether*, receipts constituted income"); *Healy* v. *Commissioner*, 345 U.S. 278, 281 (1953) (the claim of right doctrine determines whether the recognition of "an

Thus, long before *Indianapolis Power*, this Court had already adopted an income test under which the governing criterion was whether the taxpayer has "complete dominion" over funds at the time of their receipt. See *Ware*, 906 F.2d at 65 (*Indianapolis Power* "reaffirmed" the "complete dominion" test as an income determinant); Coven, *Redefining Debt: Of* Indianapolis Power *And Fictitious Interest*, 10 Va. Tax Rev. 587, 594 (1991) (*Indianapolis Power* was "entirely consistent" with earlier decisions in which "the question of taxation was resolved solely by reference to the taxpayer's legal entitlement to retain the principal amount of the receipt").

Over the years, the "complete dominion" test of *Glenshaw Glass* and its progeny has been applied to a broad spectrum of "accessions to wealth" to determine whether they constituted income to the recipients.[3] Nevertheless, the Seventh Circuit failed to apply the "complete dominion" test

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amount otherwise includible in income" can be deferred beyond the year of receipt).

[3] The complete dominion test has been applied, for example, in *Commissioner* v. *Kowalski*, 434 U.S. 77, 82-84 (1977), to determine if state troopers' cash meal allowances are income, and in *Adkins* v. *United States*, 882 F.2d 1078, 1080 (6th Cir. 1989), to determine whether lump-sum settlements of suits to recover terminated pension benefits constitute income. See also, *e.g.*, *Stovall* v. *Commissioner*, 762 F.2d 891, 893-894 (11th Cir. 1985) (investors' funds diverted by commodities broker); *United States* v. *James*, 333 F.2d 748, 752-753 (9th Cir.) (court-ordered allowance paid to widow by husband's estate), *cert. denied*, 379 U.S. 932 (1964); *Simmons* v. *United States*, 308 F.2d 160, 167-169 (4th Cir. 1962) (cash prize awarded for catching tagged fish); *Goldstein* v. *Commissioner*, 73 T.C. 164, 166 (1979) (funds provided by VISTA to pay volunteer's food and lodging costs).

in this case. Instead, it restricted this Court's holding in *Indianapolis Power* to the narrow question whether an amount received by a taxpayer is a taxable "advance payment" or a nontaxable "deposit," and concluded that it did not apply to the facts of the instant case. App., *infra*, 14a-15a.

This Court's ruling in *Indianapolis Power* was not based, however, on some talismanic difference between a "deposit" and an "advance payment"; its ruling rested on the rights and obligations of the parties at the time of the payment under the "complete dominion" standard. Thus, the Court did not merely provide a test for distinguishing between two types of payments from a customer to a taxpayer; nor did it enunciate a rule of law that applied only to determining the taxability of customer deposits. The holding of *Indianapolis Power* can no more be restricted to cases involving customer deposits than the holding of *Glenshaw Glass* can be restricted to cases involving treble antitrust damages. The Court applied a general legal standard to the facts before it to determine whether certain receipts constituted taxable income. See *Kansas City Southern Indus., Inc.* v. *Commissioner*, 98 T.C. 242, 261 (1992) (in *Indianapolis Power* "the phrase 'complete dominion' used in *Commissioner* v. *Glenshaw Glass Co., supra,* was specifically placed in the context of customer deposits").

As we have explained (*supra*, at 11-14), this standard applies with equal force to the characterization of excess interest and plainly shows that it was not income to Continental upon receipt. Inexplicably abandoning *Indianapolis Power's* "complete dominion" test, however, the Seventh Circuit held that there are *no* clear rules for income determination that apply in a case such as this, and that "much therefore must be left to the Internal Revenue Service's

discretion." App., *infra*, 15a. The court then held that the Service's discretion had not been abused. It based that conclusion on amorphous comparisons to refunds by sellers of goods. The court compared Continental's position with regard to excess interest received from CAP loan borrowers to that of a seller of goods who may have to refund the purchase price of the goods if they prove "defective or the seller br[eaks] the contract of sale in some other way," or if the seller has promised to "rebate a portion of the purchase price if the customer establishes that he could have bought the same good from another seller at a lower price." *Id.* at 14a-15a. "Guarantees of this sort * * * reduce the certainty of the seller's income stream but do not convert income into the equivalent of a deposit or bailment," the court reasoned, and the IRS could reach the same conclusion as to Continental's receipt of excess interest. *Id.* at 15a.

These vague analogies are wholly inapposite. To begin with, the supply of a defective product that results in an obligation on the part of the seller to refund the purchase price is a contingency firmly within the seller's control. Hence, it is quite unlike Continental's contractual obligation to refund excess interest, which was defeasible only by market interest rates and customer decisions that the bank could not command. Likewise, a seller who offers a price guarantee and makes a refund of part of the purchase price after the customer finds the product elsewhere at a lower cost exercises a measure of control over the event giving rise to its obligation to make a refund. In this respect, the seller in each of the court of appeals' examples is more like the recipient of an advance payment who is "assured that, so long as it fulfills its contractual obligation" — to provide merchandise free of defects or to sell at the lowest price — "the money is its to keep." *Indianapolis Power*, 493 U.S. at 210. Beyond this, both of the Seventh Circuit's analogies

are entirely academic. Refunds in the contexts relied upon by the court of appeals are almost certain to occur within the same tax year as the original receipt, thereby making the question of whether and when income was realized of only theoretical interest.

The court of appeals' flawed analogies, which it substituted for the clear standards set out in *Indianapolis Power*, are thus an insufficient basis for determining whether a receipt constitutes taxable income. This Court should grant certiorari in this case to restore predictable and stable standards governing the question whether funds received subject to an obligation to repay must be reported as taxable income.

III. THE SEVENTH CIRCUIT'S ERRONEOUS DECISION CREATES SUBSTANTIAL UNCERTAINTY AS TO THE TAX CONSEQUENCES OF A BROAD RANGE OF COMMON COMMERCIAL TRANSACTIONS

The question presented in this petition is of exceptional practical importance. Continental itself now faces tax demands in excess of $26 million for the years in issue as a result of the court of appeals' ruling. Other banks that participated as co-lenders with Continental in making CAP loans are also adversely affected by the Seventh Circuit's decision. So are banks and other financial institutions that have loaned money on similar terms.

Beyond the substantial impact of the Seventh Circuit's ruling on lenders, the court of appeals' restrictive reading of *Indianapolis Power* imposes burdens on a broad range of other business enterprises that receive money subject to contractual limitations on their right to retain it. As the Solicitor General recognized when he sought certiorari in *Indianapolis Power*, the standards for identification of

income delineated in that case "swee[p] quite broadly." They cannot be limited to a narrow set of facts, but "have ramifications outside the utility context" and concern "the tax treatment * * * of [other] forms of prepayment." Petition for Certiorari at 14, *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990) (No. 88-1319). Emboldened by the Seventh Circuit's endorsement of its misconstruction of *Indianapolis Power*, the IRS is unlikely to forego the opportunity to demand that taxpayers include refundable receipts of all kinds in taxable income.

The Seventh Circuit's ruling that *Indianapolis Power's* "complete dominion" test applies only to deposits — and not generally to funds received under an obligation to repay contingent on factors outside the recipient's control — casts serious doubt over the tax treatment of many commonplace commercial transactions. Railroads, for example, routinely agree to refund monies received from customers to cover the cost of building sidetracks to service those customers, provided such customers do a specified amount of business with the railroad. Relying on *Indianapolis Power*, the Tax Court has recognized that receipts from these sidetrack agreements are not income. *Kansas City Southern Indus., Inc.* v. *Commissioner*, 98 T.C. 242 (1992). The court of appeals' decision in this case creates uncertainty about the continuing vitality of that rule. It also raises serious doubt about the treatment of retainers paid to law firms and businesses across the country. While the recipient of a retainer may set off fees as they accrue, it has a contractual obligation to make a refund of any part of the retainer that remains after all fees have been paid. As a result, such retainers — prior to the Seventh Circuit's decision — generally have not been consid-

ered income upon receipt. Similar transactions abound throughout our economy.[4]

Given the inclusion of provisions for refunds in many ordinary transactions, the Seventh Circuit's abandonment of *Indianapolis Power's* precise standards for the identification of income in favor of loose analogies and deference to unstructured agency "discretion" will predictably have adverse practical consequences. The Solicitor General urged that the petition for certiorari in *Indianapolis Power* be granted because the court of appeals had adopted a test that "introduce[d] uncertainty" about what receipts constituted income and that was "much too amorphous and imprecise to provide an acceptable level of predictability for tax planning." Petition for Certiorari at 13-14, *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203 (1990) (No. 88-1319). In subsequently adopting the "complete dominion" test, this Court set out clear standards that significantly improved "administrative convenience [and] reduc[ed] the complexity of our system of taxation." Willock, Comm'r *v.* Indianapolis Power & Light Co.*: When are Deposits Taxable?*, 17 J. Corp. Tax'n 240, 250 (1990). The Seventh

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[4] Commonplace "true-up" provisions in sale of business transactions are subjected to uncertainty by the Seventh Circuit's ruling. In a sale of business transaction, the acquisition agreement frequently provides for repayment of part of the purchase price held in escrow after the sale has closed, to reflect the value of inventory at closing and earnings generated by the business prior to closing. Despite these contingencies, the Seventh Circuit's decision would require income recognition. Also cast in doubt by the court of appeals' ruling is the tax treatment of common agreements by mutual funds to repay customers part of the initial load charged for fund purchases if the investment reaches a specified level.

Circuit's opinion, which has substituted an amorphous deference to discretion standard for the complete dominion test, has once again obscured the requirements of the law and left taxpayers uncertain of the tax consequences of their actions.

This Court has often noted that "bright-line rule[s]" in the tax area are especially important because they "encourag[e] settled expectations" and thereby foster rational business decision-making and "reduc[e] litigation concerning * * * taxes." *Quill Corp.* v. *North Dakota*, 112 S. Ct. 1904, 1915 (1992). See, *e.g.*, *Allied-Signal, Inc.* v. *Director, Tax'n Div.*, 112 S. Ct. 2251, 2262 (1992) ("well-established rules" relating to taxation enable corporations to "structur[e] their activities"; eroding those rules "would disrupt settled expectations in an area of the law in which the demands of the national economy require stability"). In discarding the clear standards laid down in *Indianapolis Power* and assuming that "[t]here is no bright line that can be used for classifying" cases like this one (App., *infra*, 15a), the Seventh Circuit has ensured that taxpayers, the IRS, and courts alike will face confusion about the most fundamental concept in the federal income tax scheme. Inevitably, this confusion will increase disputes over whether payments received by a taxpayer subject to an obligation to repay constitute income; and it will create uncertainty about corporate income tax liabilities that can only multiply burdensome and unproductive litigation. This Court's intervention is essential to reaffirm *Indianapolis Power's* "complete dominion" test and to prevent needless litigation about the meaning of the term "income."

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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OCTOBER 1993

APPENDICES

The court of appeals' opinion, *Continental Illinois Corp.* v. *Commissioner*, 998 F.2d 513 (7th Cir. 1993), addresses appeals from three separate judgments of the Tax Court. The portion of the opinion concerning CAP loans, which is relevant to the instant petition for certiorari, begins at Pet. App. 13a.

APPENDIX A

CONTINENTAL ILLINOIS CORPORATION,

ALSO KNOWN AS

CONTINENTAL BANK CORPORATION,

PETITIONER-APPELLANT, CROSS-APPELLEE,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT-APPELLEE, CROSS-APPELLANT.

Nos. 92-2435 and 92-3191

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

ARGUED MAY 3, 1993

DECIDED JULY 9, 1993

Appeals from Orders of the United States Tax Court.

Before POSNER and COFFEY, *Circuit Judges*, and WILLIAMS, *Senior District Judge.**/

POSNER, *Circuit Judge*. The Internal Revenue Service assessed substantial deficiencies against the Continental Illinois National Bank for the years 1975 through 1979. Continental challenged these deficiencies in the Tax Court, which conducted several trials that have produced the rulings, some in favor of Continental, some in favor of the IRS, that the parties have brought before us on this appeal and cross-appeal. 55 T.C.M. (CCH) 1325 (1991); 58

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*/ Hon. Spencer M. Williams of the Northern District of California, sitting by designation.

T.C.M. (CCH) 790 (1991); 61 T.C.M. (CCH) 1916 (1991). The parties and the amici have favored us with more than two hundred pages of briefs, rich in detail that we can ignore. The issues are straightforward. They concern just two types of loan: "net loans" made to foreign borrowers, and "CAP loans."

"Net loans" are loans net of any tax that the borrower's country imposes on the interest. In a gross loan, the parties agree to an interest rate, and the interest is paid to the lender subject to any obligation that local law imposes on the borrower to withhold the tax that the lender owes on the interest. Thus, if the agreed rate of interest is 12 percent and the withholding rate 25 percent, the borrower remits only 9 percent interest to the lender and pays the rest to the local taxing authority. In a net loan, the parties agree upon the interest that the lender will be entitled to receive net of any local tax on it; this protects the borrower against an unexpected increase in the tax rate. Determination of the tax due on the interest for such a loan generally requires computing a grossed-up interest income figure (which we'll call x) that will generate the same amount of tax that would have been due had the form of the loan not been changed from gross to net. To compute x requires first computing what we will call r, the rate that, after subtraction of (in our example) 25 percent of the rate, equals the agreed-upon after-tax interest rate. So: $r - .25r = 9\%$; $r = 12\%$. The grossed-up income (x) is simply r times the amount of the loan. What we are calling x and r will nowhere be specified in the loan contract. They are artifacts created in order to make sure that net lending will not be used to reduce the lender's tax liability to the foreign country. In both the gross and the net loan the lender receives (in our example) 9 percent on his money after tax. The difference is that in the gross loan a change in the tax rate will raise or lower the

amount of money the lender can take out of the country because his entitlement is to interest before the tax on it is computed or paid, and a change in the tax rate will therefore change what he can take out, while in a net loan a change in the tax rate will not affect the amount of money that he can take out of the country because the contract for such a loan entitles him to a fixed amount of interest over and above the local tax, whatever that tax may be.

The Internal Revenue Code allows a taxpayer to credit against the federal income tax that he must pay on income earned in a foreign country any income tax that he paid to that country on the same income. 26 U.S.C. § 901. In our example of a gross loan, the lender can thus set off the 3 percent interest that is withheld from his foreign interest income and paid over to the foreign taxing authority against his federal tax obligations. In the case of a net loan, however, for a long time either the IRS took the position, or Continental believed it was the IRS's position, that the only taxable income received by the lender was the agreed-upon after-foreign-tax rate; since no foreign tax had been taken out of *that* income, no foreign tax credit was available. In 1976 Continental learned that it was the IRS's position that the lender's taxable income was x, the grossed-up amount, and that any foreign tax paid on x could be taken as a foreign tax credit. Continental launched a study of all its net loans to determine how much foreign tax had been withheld, and it attempted to credit the amounts withheld against its federal income tax, restating its taxable income to include those amounts. In terms of our example, it reported x as taxable income and claimed a foreign tax credit of .25x. We shall see that this restatement promised Continental a net tax savings.

The first issue is whether Continental's inability to produce tax receipts for the amounts withheld is fatal to its claiming those amounts as foreign tax credits. Continental makes two arguments that it is not, one that the Tax Court correctly rejected, the other that it erroneously accepted. The first argument is that the foreign tax credit attaches irrevocably when the borrower (or other foreign debtor of the U.S. taxpayer) "withholds" for taxes moneys that would otherwise go to the lender (or other U.S. creditor), even if those moneys are never paid over to the foreign taxing authority. We disagree. Put aside the awkwardness that the "withholding" involves no subtraction from what would be due the lender were there no foreign tax, because the lender's entitlement is net of that tax. The important point is that it is a foreign tax credit that the Internal Revenue Code allows, not a foreign fraud credit. If Continental's position prevailed, American businessmen would have strong incentives to collude with foreign businessmen in overwithholding foreign taxes, since such overwithholding would generate foreign tax credits for the American at no cost to the foreigner. It is true that if the foreigner withholds more than is actually due (or collectable), pocketing the difference, the American will have a higher taxable income. But every extra dollar of taxable income will be creditable against U.S. income tax, and the result will be a net tax benefit. Suppose the American is in the 30 percent bracket. Then the phantom additional dollar of foreign income will create a 30¢ tax liability and a $1 tax benefit, for a net benefit of 70¢.

This is reason enough why the IRS insists that the foreign tax not merely be withheld, but paid to the lawful taxing authority. And it is an insistence grounded in the language of the Internal Revenue Code. The amount allowed as a foreign tax credit is the amount of any foreign tax "paid

or accrued," and if accrued taxes when paid differ from the amount of the credit taken that amount must be readjusted accordingly. 26 U.S.C. §§ 901(b)(1), 905(c).

Continental presented letters from its borrowers stating that they had indeed paid the taxes they withheld on Continental's net loans. These letters are the basis of its second argument, which the Tax Court accepted, that even if the foreign tax credit does not attach at the moment of "withholding," actual payment was adequately proved. The regulations require that the taxpayer submit the "receipt for each such tax payment," or in lieu thereof "a photostatic copy of the check, draft, or other medium of payment showing the amount and date thereof, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his own tax on his own income." Treas. Reg. §§ 1.905-2(a)(2), 2(b)(1). The borrowers' letters did not comply with these straightforward requirements. We cannot imagine on what basis the requirements might be thought an abuse of the Internal Revenue Service's necessarily broad power to prescribe the methods of proving entitlement to lucrative tax benefits. Continental complains that the enforcement of the requirements against it is "unfair," because, had it only realized before 1976 that net loans could generate foreign tax credits, it would have required its borrowers to furnish it with tax receipts. But that is tantamount to arguing that the IRS was under a judicially enforceable obligation, when it changed its position on the foreign tax credit status of net loans (*if* it changed its position—which is unclear, but also on the view we take of the case unnecessary to clear up), to relax its normal rules for proving payment of foreign taxes so that taxpayers could take maximum advantage of the new position. In effect, by not relaxing its rules on proof, the

IRS changed its position on the foreign tax credit status of net loans prospectively. Continental insists on full retroactivity. There is no basis in law, public policy, natural justice, or any other source of norms for such an insistence with respect to so artificial an entitlement as the foreign tax credit. Continental's argument is even weaker if there was no change in the IRS's position in 1976—if Continental just awakened then to the possibility of obtaining foreign tax credits for interest income on net loans. It would be remarkable for a corporate taxpayer to seek to shift to the Internal Revenue Service the burden of its own lack of diligence in exploiting opportunities for tax savings.

But Continental is on solid ground in arguing that if it is not entitled to the foreign tax credits, its taxable income on the net loans should be restated from (in our example) 12 to 9 percent. Had it not learned in 1976 that it could obtain foreign tax credits on the interest income generated by its net loans, it would have reported as taxable income merely the agreed-upon net interest rate. In 1976 it saw an opportunity to make money by increasing its reported income to the grossed-up level (x) and taking the difference as a foreign tax credit, since, as we have pointed out, reporting an extra dollar of income confers a net benefit on a taxpayer who can simultaneously claim an extra dollar of foreign tax credit. The attempt to take advantage of a lawful opportunity to save taxes failed because of difficulties of proof, and the logical, practical, and legal consequence is to return to square one, where Continental's taxable income is the interest it actually received. The tax years about which the parties are wrangling are "open," meaning that no final determination of Continental's tax liability for those years has been made; and there is no suggestion that a restatement of its interest income for those years would confer a windfall on Continental. It would be the tax equivalent of entrapment for

the IRS, having in effect invited Continental to restate its net loan income in a form that would permit the bank to claim foreign tax credits, now to insist on taxing the bank on a phantom income figure—the x rate that would have benefited Continental had its claim of foreign tax credits been accepted but that confers no benefit now that the claim has been rejected.

The IRS's argument that Continental has failed to prove that the foreign taxes were *not* paid (for if they were paid, then Continental's income really was x) is barred by the doctrine of judicial estoppel, which forbids a litigant to repudiate a legal position on which it has prevailed. It is true that the doctrine is usually applied to successive suits, *Astor Chauffeured Limousine Co. v. Runnfeldt Investment Corp.*, 910 F.2d 1540, 1547-48 (7th Cir. 1990), but it is not so limited. *Witham v. Whiting Corp.*, 975 F.2d 1342, 1345 (7th Cir. 1992). A party can argue inconsistent positions in the alternative, but once it has sold one to the court it cannot turn around and repudiate it in order to have a second victory, which is what the IRS is seeking here. Having persuaded us to reject Continental's effort to show that the taxes were paid, the IRS may not argue against a restatement of income on the ground that they really *were* paid. Either they were or they weren't. If they were, Continental is entitled to a foreign tax credit, and if they weren't, it is entitled to restate its income to take the foreign taxes out.

The IRS argues in the alternative (!) that if the taxes were not paid, Continental's only remedy is to claim a bad-debt deduction against income in the year in which the borrower reneged on its implied obligation to pay the local tax on interest income earned by Continental. Such an implied obligation would arise if, should the borrower fail to pay the tax, Continental would be liable to the foreign taxing

authorities, for if so the borrower is obligated to Continental to pay the local tax due on the interest income generated by the loan. But there is no indication that any such indication either existed or was violated. The taxes may have been paid after all, or may never have been due, or, what the IRS itself treats as the same thing (Technical Advice Memorandum 86-17-003 (Dec. 30, 1985)), the tax law of the foreign country might not be enforced, or Continental may have borne no residual liability for the tax (the case in Brazil, as we are about to see). Judicial estoppel prevents our considering the first possibility; the others are ones in which there was (either de jure or de facto—and we have noted that the IRS treats these the same) no obligation to the foreign authorities, hence no implied obligation to Continental, hence no debt to go bad. We conclude that Continental is entitled to restate its income to take out the foreign taxes on which foreign tax credits were disallowed.

Net loans that Continental made to Brazilian borrowers raise a separate issue. Here Continental was able to satisfy the IRS that the local taxes really had been paid by the borrowers, but the IRS still refused to allow foreign tax credits, and this on two grounds. The first, which the Tax Court correctly rejected, is that under Brazilian law the tax is not on the lender at all, but, although called a withholding tax and computed on the basis of the lender's Brazilian income, on the borrower. The argument is semantic. Brazilian law makes the borrower exclusively responsible for paying the tax only in the sense that there is no remedy against the lender if the borrower fails to pay, whereas in some other countries the taxing authorities can go after the taxpayer himself if the employer or other withholder absconds. This is a distinction without a difference as far as foreign lenders to Brazilian borrowers are concerned. The Brazilian banking authorities will not allow a Brazilian

borrower to buy foreign currency with which to pay interest to an American lender unless the borrower establishes that he has withheld and remitted the proper amount of taxes.

Naturally the Brazilian and American tax systems are not identical, but the differences between them with respect to withholding are too minor to justify a conclusion that Brazil is "really" taxing the borrower and not the lender. The essential similarity is that the tax is based on the income received by the lender. Such a tax is an income tax. Actually it is a gross-receipts tax rather than an income tax, because the cost of lending is not netted out of the interest received by the lender. But the IRS treats it as an income tax, and the correct characterization is not important to this case. See Private Letter Rul. 76-1123-9900A (Nov. 23, 1976); 1 Joseph Isenbergh, *International Taxation* ¶¶ 18.4-18.7, 18.26-18.29, at pp. 497-502, 526-29 (1990). At all events, the tax is "paid" by the lender even if the borrower operates as his agent for payment and even if the tax enforcement guns are trained on the agent rather than on the principal. *Citizens & Southern Corp. v. Commissioner*, 919 F.2d 1492 (11th Cir. 1990), affirming without opinion *Continental Illinois Corp. v. Commissioner*, 55 T.C.M. (CCH) 1325, 1330 (1988); *Nissho Iwai American Corp. v. Commissioner*, 89 T.C. 765, 773-74 (1987).

The second ground for rejecting foreign tax credits on the Brazilian net loans, the ground the Tax Court correctly in our view accepted, is that beginning in 1975 the Brazilian government rebated most of the withheld taxes. (The part not rebated is entitled to foreign tax credit.) The year before, in an effort to stimulate foreign investment, the Brazilian government had slashed the tax rate on interest on foreign loans from 25 percent to 5 percent. This was fine for net loans, but had a boomerang effect on gross loans,

though they were a distinct minority of all foreign loans. The tax cut increased the amount of foreign currency that the borrower had to buy to pay interest on a gross loan. Before on a 12 percent gross loan the borrower had paid 9 percent in foreign currency to the lender and the rest to the government in cruzeiros; now the borrower paid 11.4 percent (.12-.05(.12)) in foreign currency to the lender. So the following year Brazil passed a law restoring the 25 percent tax rate but rebating 20 percent to the borrowers, leaving the latter with a 5 percent effective tax rate. Continental claims to be entitled to treat the full 25 percent as a foreign tax that it can credit against its U.S. tax liability. The IRS argues that the 25 percent must be reduced by the rebate, so that the creditable tax rate is only 5 percent.

The IRS has two grounds, both accepted by the Tax Court, only one unsound. The unsound one is based on the principle of substance over form: an arrangement that has no rationale other than to beat taxes can be disregarded. *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); *Bramblett v. Commissioner*, 960 F.2d 526, 533 (5th Cir. 1992). To rebate local taxes merely to generate foreign tax credits for a U.S. taxpayer to the ultimate benefit of the locals who do business with that taxpayer would qualify for the application of this principle. But as Continental points out, there is no evidence that this was the purpose of the rebate or the only effect. Brazil did want to preserve its stimulus for foreign investment yet stem a foreign-currency hemorrhage, and it chose a method of doing so that it might have chosen were there no U.S. foreign tax credit, for the rebate lowered the costs of Brazilian borrowers from foreign banks without increasing the amount of foreign currency that had to be paid those banks in the short run.

The other ground for knocking down the foreign tax credit to the post-rebate tax rate is Temp. Treas. Reg. § 4.901-2(f)(3), 45 Fed. Reg. 7563 (Nov. 17, 1980), 26 C.F.R. § 4901-2(f)(3) (1981) (and, for Continental's 1978 taxable year, a revenue ruling to the same effect, Rev. Rul. 78-258, 1978-1 Cum. Bull. 239), which disallows foreign tax credit to the extent that the tax is used to subsidize the taxpayer. The temporary regulation is defunct, but its principle, and indeed virtually its exact words, have now been incorporated into the Internal Revenue Code. 26 U.S.C. § 901(i).

"Subsidy" is a tricky concept. It is by no means clear that the Brazilian tax rebate subsidized, in the sense of conferring an actual benefit upon, American net lenders like Continental. Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes," 39 *Tax L. Rev.* 227, 244-47 (1984); 1 Isenbergh, *supra*, ¶ 18.10.2 at pp. 507-08. Indeed, insofar as the interest rate had been fixed in the loan contract before the rebate was instituted, only the borrowers benefitted; for we noted at the outset that the difference between a net and a gross loan is that a net loan allocates the risk and benefit of any change in the tax rate to the borrower because the lender's return is specified net of tax. Even if not frozen by the contract the interest rate might not rise by the amount of the subsidy. It is true that the subsidy would make the borrowers more eager to take out foreign loans and that an increase in demand usually results in an increase in price, but the increase in demand need not be proportionally equal to the increase in price and it would be tempered here by competition among the foreign lenders; also, Brazil imposed ceilings on interest rates. Figuring out who gets how much of the benefit of a subsidy is like figuring out who really pays a tax, since the nominal taxpayer has an incentive to shift it as best he can forward or

backward. It all depends on contract terms and on conditions of demand and supply.

The IRS regulation (now codified by Congress, as we noted) elides a difficult factual inquiry by deeming the taxpayer subsidized if the country subsidizes a person with whom the taxpayer "engages in a business transaction," provided the subsidy "is determined directly or indirectly by reference to the amount of income tax . . . imposed by the country on [that] person with respect to such transaction." Temp. Treas. Reg. § 4.901-2(f)(3)(ii)(B). That description fits this case to a t. The borrower gets the subsidy, he engages in a business transaction with the U.S. taxpayer (the loan), and the subsidy is measured by the local tax on the U.S. lender's local income; it is 80 percent of that tax (20%/25%). The regulation is clear as a bell, and its validity cannot seriously be questioned, even if we disregard its later codification by Congress. Just as the IRS must be given leeway in deciding what proof to require that a tax has actually been paid, so it must be given leeway in deciding when a rebate to a foreign business partner of a U.S. taxpayer should be deemed a subsidy to the taxpayer, disentitling him to a foreign tax credit. The IRS can hardly be faulted for having chosen a bright-line approach in preference to interminable investigation of the mysteries of public finance, much as the latter approach might appeal to the legal, accounting, and economic-consulting communities. The Supreme Court has chosen a similar bright-line approach for resolving the analytically identical problem posed by the passing-on of price increases by antitrust plaintiffs. *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977). See also *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 46-47 (1990).

We need not discuss separately the so-called "repass" loans, where the subsidy was paid not to the borrowers but to local banks with which Continental transacted—but the banks were required to pass the subsidy on to the borrowers. These loans fell within the letter as well as the spirit of the subsidy regulation. The statutory codification eliminates all possible doubt for the future. 26 U.S.C. § 901(i)(1).

The last issue we discuss is whether the Tax Court was correct to require Continental to report as income interest that the bank received subject to a contingent obligation to rebate it to the borrower. Beginning in 1972 Continental offered what it called "CAP" loans to some of its corporate borrowers. These loans usually had a fixed term of five to ten years. Interest, rather than being fixed in advance, was computed as a percentage of or over the prime rate. This floating rate was capped by a fixed rate specified in the loan contract, and Continental agreed that if at the expiration of the loan the borrower had neither defaulted on nor prepaid the loan Continental would refund any interest that it had received above the cap rate. When Continental received an interest payment that exceeded the cap rate (because the floating rate had floated above it), it reported only the cap rate as income. The excess it carried on its books "as interest collected but not earned." If it received an interest payment that was below the cap rate because the floating rate was below it, it would treat the payment as income, and if there was a balance in the borrower's "interest collected but not earned" account it would add to the interest payment that it had received so much of the balance in the account as necessary to equal the cap rate, and it would treat the sum as income, debiting the borrower's excess-interest account.

When Continental instituted its CAP loan program it thought the cap rate would on average exceed the floating rate; it was offering the borrowers insurance rather than a lower expected price of money. But because of the unexpectedly steep inflation during the 1970s, the floating rate regularly pierced the cap, requiring Continental to make substantial refunds to its borrowers. It claims not to be required to treat any interest it received above the cap rate during the life of the loan as income, since such receipts were subject to a contractual obligation to be refunded at the expiration of the loan.

Not every receipt is income. A deposit, for example, is not. *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990); *Illinois Power Co. v. Commissioner*, 792 F.2d 683, 689-90 (7th Cir. 1986). The recipient—bank, landlord, electric utility, whatever—holds the money under obligation (albeit defeasible) to return it. On the other hand income does not cease to be such because there is some likelihood that the recipient may have to give it back. For there is always *some* likelihood of that. The income that a seller receives from the sale of goods may have to be refunded because the goods were defective or the seller broke the contract of sale in some other way—and some sellers offer to take goods back and refund the buyer's money with no questions asked. A seller who offers a discount for customers who buy a minimum amount in the course of a year receives income from those customers subject to a contingent obligation to repay a portion to those customers who reach the minimum. Such contingencies have never been thought to entitle a seller to delay recognizing income until the time during which the contingencies could have materialized is past.

Ours is an intermediate case. The seller (here the lender) is not merely holding the money that he receives from the sale of his goods (or here the rent of his money) in the account of the buyer (borrower), as if it were a deposit; but the likelihood that he will have to repay much or even all of this "income" to the customers is substantial. There is no bright line that can be used for classifying such a case, and much therefore must be left to the Internal Revenue Service's discretion, *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532-33 (1979), not here abused. When Continental embarked upon its CAP loan program it expected to be able to keep the interest generated by the floating rate. The cap was for insurance. It was like a guarantee, specifically like a seller's promise to rebate a portion of the purchase price if the customer establishes that he could have bought the same good from another seller at a lower price. Guarantees of this sort resemble warranties against defective goods. They reduce the certainty of the seller's income stream but do not convert income into the equivalent of a deposit or a bailment.

No other issues need be discussed. The judgment of the Tax Court is affirmed in part and reversed in part, as indicated in this opinion, and the case is remanded to that court for such further proceedings as may be appropriate in light of this opinion.

APPENDIX B

T.C. Memo. 1989-636

UNITED STATES TAX COURT

CONTINENTAL ILLINOIS CORPORATION, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 5931-83. Filed November 28, 1989.

CINB, a bank wholly owned by petitioner, extended loans to borrowers pursuant to loan agreements which provided an interest rate cap, but called for interest payments at a floating rate which was tied to CINB's prime rate. Under certain conditions, borrowers were entitled at maturity of their loans to repayment of interest to the extent that payments made at the floating rate exceeded payments which would have been made at the cap rate. The amount of interest which was subject to repayment by CINB was not included as income on the consolidated returns that petitioner filed for the years in issue. ***Held:*** **Respondent's determination under section 446(b) is sustained, and interest income must be accrued on such loans at the floating rate at which borrowers made interest payments.** ***Held further:*** **Respondent's determination under section 481, relating to adjustments required by changes in accounting method, is sustained.**

Edward C. Rustigan, Joel V. Williamson, Roger J. Jones, and Lloyd S. Fischer, 190 S. LaSalle St., Chicago, Ill., for the petitioner. Beth L. Williams, Robert A. Bedore, Cynthia J. Mattson, and Grace L. Perez-Navarro, for the respondent.

Memorandum Findings of Fact and Opinion

WHITAKER, Judge: By statutory notice dated December 20, 1982, respondent determined deficiencies in the Federal income tax of petitioner, Continental Illinois Corporation (Continental Illinois), and the affiliated corporations with which it filed consolidated returns, including Continental Illinois National Bank and Trust Company of Chicago (CINB), as follows:

Year	*Deficiency*
1975	$ 1,899,880
1976	84,088
1977	36,741,206
1978	15,844,349
1979	3,896,519

Pursuant to joint motion, the Brazilian foreign tax credit issue was severed from the other issues, consolidated with another case, and tried at a special trial session in Washington, D.C. See *Continental Illinois Corp. v. Commissioner*, T.C. Memo 1988-318. By order dated April 12, 1989, the issue known as the "Iranian Loss" issue was severed from the remaining issues in the case.[1] Those remaining issues known as the "CAP Loan" issue and the "Net Loan" issue, which involve only the years 1977 through 1979, were tried at a special trial session that commenced in Washington, D.C., on May 8, 1989. As a

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[1] The remaining issues were described in that order as "Non-Iranian Loss" issues.

preliminary matter, certain evidentiary issues which arose in connection with the "Net Loan" issue were resolved pursuant to *Continental Illinois Corp. v. Commissioner*, T.C. Memo 1989-468. This opinion covers only the "CAP Loan" issue; the remaining "Net Loan" issue will be the subject of a later opinion.

The primary issue to be resolved with respect to the CAP Loans is whether respondent abused his discretion under section 446(b)[2] by determining that CINB's income tax accounting method, which was in conformity with its financial and regulatory accounting method, did not clearly reflect interest income with respect to such loans.

Findings of Fact

Some of the facts have been stipulated and are found accordingly. The stipulations and exhibits attached thereto are incorporated herein by reference except as otherwise provided in the order which was issued in conjunction with our opinion resolving the evidentiary issues.

Continental Illinois is a Delaware corporation which had its corporate headquarters in Chicago, Illinois, at the time it filed its petition herein. Continental Illinois maintains its books and files its tax returns on an accrual basis. Continental Illinois and a group of affiliated corporations filed consolidated Federal income tax returns for each of the relevant calendar years. Included in that group is CINB, a Federally incorporated national banking association wholly owned by Continental Illinois. CINB made the CAP Loans which are the subject of this opinion.

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[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954, as in effect for the years in issue.

Beginning in 1972 and continuing for more than a decade thereafter, CINB made loans known in banking parlance as "CAP Loans" to certain creditworthy corporate borrowers. CINB had CAP Loans outstanding to 61 borrowers during the years in issue. CINB was the sole or lead lending bank with respect to most of those CAP Loans and a participating lending bank with respect to the rest. With the exception of one revolving credit loan, the CAP Loans at issue were loans CINB made for specified terms, typically ranging from 5 to 10 years.

CINB made CAP Loans pursuant to agreements which called for the payment of interest at a floating rate determined as either a percentage of CINB's prime rate (*e.g.*, 120 percent of prime) or an interest point spread above CINB's prime rate (*e.g.*, prime plus 2 percent). CINB's prime rate was the publicly announced rate of interest which CINB offered at Chicago for 90-day unsecured commercial loans to large corporate customers of the highest credit standing.[3] The prime interest rate, and thus the floating interest rate, changed numerous times during the years in issue. According to the CAP Loan agreements, if certain conditions were satisfied, borrowers were entitled at or after maturity to any excess interest paid to CINB over the term of the loans. The amount of excess interest,[4] if any, to be

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[3] When the lead lender was another bank, prime was generally defined by reference to the prime rate of interest announced by that bank.

[4] The term "excess interest" as used herein is intended to be without prejudice to either party, particularly with respect to how amounts thereof are treated for purposes of Federal income tax. Repayments of excess interest to borrowers are referred to in bank parlance as "rebates."

repaid to a borrower by CINB was determined by comparing the total amount of the actual interest payments made by such borrower over the term of the loan with the total amount of interest payments which would have been made by such borrower at the agreed upon CAP rate over the term of the loan. The CAP rate was a fixed percentage rate (*e.g.*, 8 percent) which did not change after it was agreed upon by the parties to a CAP Loan agreement.[5]

The CAP Loan agreements called for borrowers to make interest payments at the floating rate either monthly, quarterly, or semi-annually. Those agreements also called for a comparative computation of interest at the CAP rate on the average principal balance outstanding at various intervals, including interest due dates, dates of any prepayment or default, and loan maturity dates. Such computations were used to determine whether payment of interest at the floating rate resulted in an excess or shortfall of interest for the particular period. A floating rate above the CAP rate resulted in excess interest and a CAP rate above the floating rate resulted in an interest shortfall. Shortfall situations occurred rarely, and with respect to some CAP Loans not at all, because interest rates during the years in which CINB had CAP Loans outstanding generally followed an upward trend. The overall increase in interest rates usually kept floating rates above CAP rates, which remained fixed at previously agreed upon levels.

For a CAP Loan with respect to which the floating rate exceeded the CAP rate, CINB accrued interest income for financial and regulatory purposes at the CAP rate and credited the excess interest to a liability account identified by

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[5] In a very few instances, a CAP Loan agreement provided for successive but differing fixed CAP rates.

it as "Interest Collected But Not Earned" (an Excess Interest account). For a CAP Loan with respect to which the CAP rate exceeded the floating rate, i.e., a shortfall situation, the amount of interest income accrued by CINB depended on the extent, if any, to which the particular borrower had previously made excess interest payments. In such a situation, CINB accrued interest income at the CAP rate, but only if and to the extent that there was excess interest available to cover the shortfall. To the extent that excess interest was not available to cover the shortfall, CINB accrued interest at the floating rate. When a shortfall was covered with excess interest, CINB made a corresponding reduction in the credit balance of the Excess Interest account established with respect to the particular borrower.

CINB enjoyed the use of all interest payments made by CAP Loan borrowers, including excess interest payments. CINB's use of such payments was subject only to the general financial and regulatory requirement that sufficient overall assets be maintained to meet its liabilities, including its obligation to repay excess interest to CAP Loan borrowers if certain conditions were satisfied. CINB commingled CAP Loan interest payments with its other funds and used such payments for various purposes permitted by the financial and regulatory authority under which it operated. Such uses included the earning of income, payment of expenses and liabilities, and investment. CINB did not pay borrowers interest on the credit balances reflected in Excess Interest accounts regardless of whether the excess interest was eventually repaid to borrowers or retained because borrowers failed to satisfy the conditions for repayment set forth in the CAP Loan agreements.

Generally two conditions had to be satisfied in order for a borrower to be entitled to receive repayment of excess

interest from CINB:[6] (1) no prepayment of principal; and (2) no default. CINB was required to repay the cumulative amount of excess interest, as reduced by shortfalls, to any borrower that satisfied both of those conditions. Repayment was generally made when the loan matured or shortly thereafter. Sometimes CINB repaid the excess interest to a borrower by applying it to the borrower's final payment of interest and principal or by crediting it to an account of the borrower. CINB reflected repayment of excess interest on its books by debiting Excess Interest accounts as appropriate.

When a borrower failed to satisfy the conditions entitling it to repayment of excess interest, CINB accrued income in an amount equal to the amount of such excess interest. CINB reflected accrual of such income on its books by crediting a miscellaneous income account and debiting the Excess Interest account of the borrower determined not to be entitled to repayment of excess interest. In certain instances, CINB waived the conditions and repaid excess interest, or a portion thereof, to borrowers not otherwise entitled to repayment under the terms of the CAP Loan agreements. When CINB repaid only a portion of excess interest it presumably accrued the remainder as income after reaching an agreement with the borrower regarding the disposition of such excess interest. Although the condition prohibiting

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[6] The conditions and the specific language implementing them vary slightly depending upon the particular CAP Loan agreement. However, neither petitioner nor respondent argues that such differences should change the result with respect to any amount of excess interest. Likewise, we do not think that such differences bear upon the resolution of the CAP Loan issue. Thus, we find present only those conditions which the parties stipulated as being generally provided in the CAP Loan agreements and we make our decision based on that finding.

prepayment was waived on a number of occasions to avoid jeopardizing relationships with particular borrowers, CINB never indicated to borrowers that it did not intend to enforce that condition.

During the years 1973 through 1987, CINB debited Excess Interest accounts established with respect to CAP Loans outstanding at any time prior to 1980 in amounts totaling $127,053,972. Those debits reflected repayments of excess interest to borrowers in the amount of $114,216,357, shortfalls in the amount of $2,753,401 which were covered by excess interest, miscellaneous income (i.e., excess interest retained by CINB) in the amount of $4,993,475, corrections of errors in the amount of $4,965,632, and $125,107 of debits the reasons for which are unknown.[7] CINB debited Excess Interest accounts in amounts totaling $14,381,389 during the years in issue. That total reflects repayments of excess interest in the amount of $11,710,814, shortfalls in the amount of $1,026,014 which were covered by excess interest, miscellaneous income in the amount of $424,390, corrections of errors in the amount of $1,217,514, and $2,657 of debits the reasons for which are unknown.

The balance in CINB's liability account "Interest Collected But Not Earned," which reflected the total of individual Excess Interest accounts, as of December 31, 1976, 1977, 1978, and 1979, as well as the net increases (decreases) in such account during those years are as follows:

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[7] Insignificant differences exist in some of the totals set forth in the Second Stipulation of Facts (CAP Loans). We assume such differences are attributable to rounding or other math errors made in the totaling process. For that reason, we rely on our own summations of the scheduled amounts in arriving at the totals set forth herein.

Year	*Ending Balance*	*Increase (Decrease)*
1976	$16,371,168	--
1977	11,577,062	($4,794,106)
1978	14,713,887	3,136,825
1979	26,010,158	11,296,271

With respect to CAP Loans, CINB accrued interest for tax purposes at the same rate and in the same manner which it used for financial and regulatory purposes. Thus, on petitioner's returns for the years in issue, excess interest was neither recognized nor reported as income until CINB determined that it was necessary to cover a shortfall or that it would be retained rather than repaid to a CAP Loan borrower.

In his notice of deficiency, respondent determined that CINB's method of reporting interest on CAP Loans did not clearly reflect income and that, in order to do so, interest income must be accrued at the floating rate at which CAP Loan borrowers agreed to make interest payments. Respondent further determined that petitioner was not entitled to deduct repayments of excess interest which CINB anticipated making to CAP Loan borrowers until the fact of repayment became certain and the amount thereof became determinable with reasonable accuracy.[8] Accordingly, respondent increased petitioner's income for 1977 by $11,577,062, an amount which reflects the beginning balance of CINB's "Interest Collected But Not Earned" account ($16,371,168) as reduced by the decrease in the balance of

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[8] Petitioner has not made any argument or statement with respect to the deductibility of anticipated repayments of excess interest. Accordingly, we do not consider that determination to be in issue.

that account which occurred during the year ($4,794,106). For each of the two succeeding years, 1978 and 1979, respondent increased petitioner's income by the amount of the increase in the balance of CINB's "Interest Collected But Not Earned" account which occurred during those years, $3,136,825 and $11,296,271, respectively.

Opinion

Section 446(a) provides the general rule that "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Under section 446(b), "If * * * the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." Subject to the requirements of section 446(a) and (b), section 446(c) permits a taxpayer to use the cash method,[9] accrual method, other statutorily permitted methods, or any combination of methods permitted under the regulations. Here, however, respondent determined that CINB's income tax accounting method, which was in conformity with its financial and regulatory accounting method, did not clearly reflect interest income with respect to CAP Loans. Thus, the primary issue raised is whether petitioner has established that respondent abused his discretion in making that determination.

A heavy burden is imposed upon petitioner to overcome respondent's determination, because section 446

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[9] For taxable years beginning after December 31, 1986, the cash method of accounting for tax reporting is not available to Subchapter C corporations with annual average gross receipts exceeding $5,000,000. Sec. 448. See Tax Reform Act of 1986, Pub. L. 99-514, sec. 801(a), 100 Stat. 2085, 2345.

vests respondent with broad discretion in determining whether a particular method of accounting clearly reflects income. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979); *United States v. Catto*, 384 U.S. 102, 114 (1966); *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959); *Lucas v. Kansas City Structural Steel Co.*, 281 U.S. 264, 271 (1930); *Molsen v. Commissioner*, 85 T.C. 485, 498 (1985).[10] However, in exercising his discretion, respondent cannot require CINB to change from an accounting method which clearly reflects income. *Prabel v. Commissioner*, 91 T.C. 1101, 1112 (1988), affd. 882 F.2d 820 (3d Cir. 1989); *Molsen v. Commissioner, supra; Bay State Gas Co. v. Commissioner*, 75 T.C. 410, 417, 423 (1980), affd. 689 F.2d 1 (1st Cir. 1982); *Auburn Packing Co. v. Commissioner*, 60 T.C. 794, 798-800 (1973); *Garth v. Commissioner*, 56 T.C. 610, 618 (1971). Whether the method used by CINB clearly reflects income is primarily a question of fact. *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521, 555 (1979), affd. 633 F.2d 512 (7th Cir. 1980). But we need not weigh and determine the relative merits of various methods of accounting. *United States v. Catto, supra,* nor need we decide if, in our own judgment, CINB's method clearly reflects income; rather, we must decide whether there is an adequate basis in law for respondent's determination that CINB's method fails to do so. *RCA Corp. v. United States*, 664 F.2d 881, 886 (2d Cir. 1981), cert. denied 457 U.S. 1133 (1982).

Respondent essentially argues that interest income accrues when the right to receive it becomes fixed, even if later events may require repayment of it. Because CINB had

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[10] *Applied Communications Inc. v. Commissioner*, T.C. Memo. 1989-469.

the right under CAP Loan agreements to receive interest payments at the floating rate, respondent further argues that interest, including that portion thereof which was accounted for as excess interest, accrued and was taxable when those payments became due and payable or when such payments were received, whichever was earlier. To the contrary, petitioner argues that CINB should be allowed to defer inclusion of excess interest in income because of its repayment obligation. In support of that argument petitioner alternatively contends that (1) neither the so-called "all events test" nor the claim of right doctrine applies with respect to excess interest, which was subject to a high probability of repayment; (2) excess interest was in the nature of a deposit with, or advance to, CINB rather than an item of gross income; and (3) those cases which forbid the deferral of prepaid income do not require inclusion of excess interest which could only be retained by CINB "upon the happening of specific (albeit improbable) events in subsequent taxable years."

Income is included in gross income in the taxable year of receipt unless accounted for in a different period under the taxpayer's method of accounting. Sec. 451(a). The cornerstone of the accrual method of accounting for Federal income tax purposes is the all events test. See, *e.g.*, *Brown v. Helvering*, 291 U.S. 193 (1934); *Lucas v. American Code Co.*, 280 U.S. 445 (1930); *United States v. Anderson*, 269 U.S. 422 (1926). The regulations describe the accrual method in the following manner:

> Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

> Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. * * *

Sec. 1.446-1(c)(1)(ii), Income Tax Regs. This description of the accrual method is repeated in the regulations under section 451, to the extent that it pertains to the accrual of income, and in the regulations under section 461, to the extent that it pertains to the accrual of expenses.

It is well established that a taxpayer who reports his income on the accrual method is subject to tax liability when the right to receive such income becomes fixed, or when the taxpayer has actually received income to which his use is unrestricted. *Brown v. Helvering, supra* at 199; *Automobile Club of New York, Inc. v. Commissioner*, 32 T.C. 906, 913 (1959), affd. 304 F.2d 781 (2d Cir. 1962). As the Supreme Court stated in *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184-185 (1934):

> Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determiñes the inclusion of the amount of gross income. When the right to receive an amount becomes fixed, the right accrues. * * * [Emphasis in original.]

In this case, CAP Loan agreements required borrowers to make interest payments to CINB at specified intervals. Thus, respondent argues, and we agree, that those agreements fixed the time of accrual because there were no

conditions precedent to CINB's right to receive interest payments with respect to CAP Loans. Cf. *Burnham Corp. v. Commissioner*, 90 T.C. 953 (1988), affd. 878 F.2d 86 (2d Cir. 1989). We emphasized the distinction between conditions precedent and subsequent in the accrual of deductions context in *Burnham Corp.*, and held that the existence of a condition subsequent which may cut off liability in the future does not prevent that liability from being fixed for accrual purposes. Likewise, the occurrence of later events which require the repayment of income does not necessarily prevent that income from being fixed for accrual purposes. *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).

When interest at the floating rate was due and payable, or paid, to petitioner, all of the events had occurred which call for the accrual of interest income. Sec. 1.451-1(a), Income Tax Regs. In our view, the obligation to refund excess interest upon satisfaction of the conditions set forth in the CAP Loan agreements constituted a continent liability which had no bearing on CINB's right to receive interest payments, including that portion of those payments accounted for by CINB as excess interest. Cf. *Fourth Financial Corp. v. Commissioner*, T.C. Memo. 1985-232.[11]

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[11] In *Fourth Financial Corp. v. Commissioner*, T.C. Memo. 1985-232, we faced the flip side of this same issue. In that case, the issue was whether interest payments made to CINB by a particular CAP Loan borrower, Fourth National Bank, were deductible in the year paid. Specifically, we analyzed the deductibility of excess interest because in that case respondent took the position that such excess interest represented nondeductible contingent interest or capital expenditures and that any subsequent repayments received by Fourth National Bank would not be taxable income. Fourth

(continued...)

Moreover, CINB received interest payments from CAP Loan borrowers under a claim of right and without restrictions. Thus we think that an adequate legal basis exists for respondent's determination that the method used by CINB fails to clearly reflect income with respect to CAP Loans.

Claim of Right Doctrine

Although this Court has not previously applied the claim of right doctrine in this particular context, CINB's receipt of interest payments on CAP Loans exhibits the factual element common to all claim of right doctrine cases, "the receipt of money or other property by a taxpayer with an imperfect right to retain it." *Nordberg v. Commissioner*, 79 T.C. 655, 664 (1982), affd. without published opinion 720 F.2d 658 (1st Cir. 1983), quoting Wootton, "The Claim of Right Doctrine and Section 1341," 34 Tax Law. 297

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[11](...continued)
National Bank, on the other hand, argued that interest payments were fully deductible in the years made because it did not have an unconditional right to repayment and the contingencies which kept that right from being unconditional were real and substantial.

Under a line of authority set forth in two prior opinions of this Court regarding the deductibility of interest payments subject to a right to reimbursement, *Sherman v. Commissioner*, 18 T.C. 746 (1952), and *Stevens Bros. Foundation, Inc. v. Commissioner*, 39 T.C. 93, 125-126 (1962), revd. on another issue 324 F.2d 633 (8th Cir. 1963), we concluded that an otherwise proper deduction could not be disallowed because of a right to reimbursement unless the taxpayer was assured of both the right to reimbursement and the amount of the reimbursement. Because all of the contingencies which fixed Fourth National Bank's right to repayment of excess interest were not satisfied by the end of the taxable year in question, we held that it was entitled to deduct the full amount of the interest payments which it had made to CINB.

(1981). The most frequently cited in a long line of cases which apply the claim of right doctrine is *North American Oil Consolidated v. Burnet, supra.* In that case, the Supreme Court required the taxpayer to include in gross income for its 1917 taxable year an amount it has received as a result of a favorable judgment even though litigation over the taxpayer's right to such income continued until 1922. The Court explained the doctrine as follows:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. * * * [Citations omitted.]

North American Oil Consolidated v. Burnet, supra at 424.

Petitioner argues that application of the claim of right doctrine does not result in a clear reflection of income because the excess interest was repaid to CAP Loan borrowers "almost without exception." Petitioner apparently makes that argument to justify CINB's departure from reporting interest income with respect to CAP Loans on the basis of its annual accounting period. However, under our Federal tax system income must be computed on an annual basis, *Healy v. Commissioner*, 345 U.S. 278, 281 (1953), and the claim of right doctrine provides a necessary finality to each such annual accounting period. *United States v. Lewis*, 340 U.S. 590, 592 (1951). Income is not computed on a transactional basis or for a period in excess of a year, except to the extent that Congress has specifically provided, as, for example, in the case of carrybacks and carryforwards.

No statutory exception exists for situations such as the one now before us.

In order for the claim of right doctrine to apply, two prerequisites must be present at the close of the period within which income is sought to be taxed. *North American Oil Consolidated v. Burnet, supra.* First, the taxpayer must claim entitlement to the funds at issue. Second, such funds must be held by the taxpayer without restrictions on disposition. In *Carlstedt Associates, Inc. v. Commissioner*, T.C. Memo. 1989-27, 56 T.C.M. 1090, 1098, 58 P-H Memo T.C. par. 89,027, 89-112, 89-120-89-121, we noted that:

> If there are no restrictions on the taxpayer's disposition of funds which it holds, yet the taxpayer never claims any entitlement to the funds, the claim of right doctrine may not require inclusion of the funds in income. Conversely, if the taxpayer claims entitlement to funds it has received, but its ability to dispose of the funds as it chooses is substantially restricted, the claim of right doctrine may not require inclusion of the funds in income. * * * [Citation omitted.]

Petitioner seeks to avoid application of the claim of right doctrine by arguing that CINB neither claimed entitlement to excess interest nor held the amounts thereof without restrictions on disposition. With respect to CINB's entitlement to excess interest, petitioner contends that CINB never contested "the right of CAP Loan borrowers to retain excess CAP Loan interest payments," that CINB established liability accounts on its books to ensure the availability of funds to repay excess interest, and that CINB repaid "virtually 100 percent" of the excess interest to CAP Loan

borrowers. With respect to the restrictions on CINB's disposition of excess interest, petitioner contends that CINB reduced its asset base for lending purposes by recording excess interest as a liability account on its books, that CINB was compelled by regulatory and financial rules to maintain sufficient assets with which to discharge its repayment obligation, and that CINB sustained substantial losses because by virtue of CAP Loan agreements it was making below-market loans. Petitioner further contends that those purported restrictions allowed CINB to enjoy nothing more than the time value of the excess interest, which it considered to be compensation for providing loans with a CAP rate to borrowers.

CINB received interest payments, including that portion thereof which was accounted for as excess interest, pursuant to CAP Loan agreements. Those agreements leave no doubt as to CINB's entitlement to the excess interest. The CAP Loan borrowers were liable for interest payments at the floating rate and CINB had the right to demand such payments and presumably would have, had such payments not been timely made. That entitlement is further demonstrated by CINB's use of excess interest for its own purposes.

CINB's repayment obligation, which was contingent on there being no shortfalls, prepayments, or defaults with respect to particular CAP Loans, does not change the fact that CINB had a claim of right to excess interest throughout the years in issue. The claim of right doctrine applies "notwithstanding that the taxpayer may be under a contingent obligation to restore the funds at some future point." *Professional Insurance Agents of Michigan v. Commissioner*, 78 T.C. 246, 270 (1982), affd. 726 F.2d 1097 (6th Cir. 1984). The mere fact that the excess interest received by

CINB may have to be returned at a later date did not deprive such excess interest of its character as taxable income when received. *Brown v. Helvering*, 291 U.S. 193, 199 (1934); *Illinois Power Co. v. Commissioner*, 792 F.2d 683, 689 (7th Cir. 1986), affg. in part and revg. in part 83 T.C. 842 (1984); *Nordberg v. Commissioner, supra* at 665; *Woolard v. Commissioner*, 47 T.C. 274, 279 (1966). If repayment of all or a part of the excess interest is required in a subsequent year, a deduction may then be available in such year.[12] *Krim-Ko Corp. v. Commissioner*, 16 T.C. 31, 40 (1951).

Petitioner's argument with respect to restrictions on CINB's disposition of the excess interest fails for the same reason, i.e., the contingent repayment obligation does not constitute a "restriction on use" sufficient to prevent application of the claim of right doctrine to excess interest received by CINB. See *Healy v. Commissioner, supra* at 284. At the close of the years in issue, CINB's repayment obligation depended on there not being any subsequent shortfalls, or prepayments or defaults by CAP Loan borrowers. Thus, it cannot be said that at the end of each of those years CINB had an existing and fixed obligation to repay excess interest to CAP Loan borrowers.[13] *Hope v.*

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[12] Under certain circumstances, section 1341 offers even greater relief by allowing the taxpayer to choose, in the year of repayment, between a deduction for the amount of the repayment and, in effect, a credit for the amount of tax that would have been saved in the year of inclusion if the repaid amount had been excluded from that year's gross income.

[13] At no time prior to loan maturity was there an existing and fixed repayment obligation. Obviously, certain CAP Loans with respect to which borrowers satisfied the conditions entitling them

(continued...)

Commissioner, 55 T.C. 1020, 1030 (1971), affd. 471 F.2d 738 (3d Cir. 1973), cert. denied 414 U.S. 824 (1973). CINB's repayment obligation was more in the nature of a "potential or dormant restriction," which the Supreme Court found to be inadequate to keep receipt under a claim of right from giving rise to income. *Healy v. Commissioner, supra.*

Nevertheless, petitioner argues that, under the so-called *Golson* rule,[14] the holding of the Court of Appeals for the Seventh Circuit in *Illinois Power Co. v. Commissioner, supra*, dictates the outcome of the CAP Loan issue. Petitioner further argues that holding "permits petitioner to exclude from income excess interest payments since it was 'not very likely' that [CINB] would ultimately retain these payments." We do not agree. The fallacy of petitioner's argument stems not from the law set forth in that case, but from the misapplication of that law to the facts of this case.

In *Illinois Power Co.*, the Illinois Commerce Commission (ICC), the agency responsible for regulating the taxpayer's rates, created a new rate classification in 1974, which had the effect of raising rates for certain commercial

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[13](...continued)
to repayment matured during the years in issue. However, we need not treat such loans separately since the method of adjustment respondent used in making his determination takes account of repayments of excess interest made with respect thereto.

[14] See *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971), under which we are required to follow a Court of Appeals decision which is squarely on point where appeal from our decision lies to that Court of Appeals.

customers. The new rate classification was intended to prompt such customers to switch to alternative fuel sources. The ICC ordered that a portion of the additional revenue resulting from the new rate classification be accumulated in a "special fund," but the taxpayer was not ordered to segregate that fund from its other funds. Consequently, the taxpayer commingled the special fund money with money from other sources and the special fund existed only as a series of entries on the taxpayer's books. Although the ICC did not specify exactly how such money was to be disgorged, i.e., when, to whom, or with what interest, until several years later,[15] it made clear from the outset that the taxpayer would not be allowed to keep any of the money which was collected.

The court held that the claim of right doctrine was not applicable since the taxpayer never had a claim of right to the special fund money. *Illinois Power Co. v. Commissioner*, 792 F.2d at 688. The taxpayer knew from the start that it would be required to repay such money with interest and, therefore, that it could derive no benefit from having held the money. Under those circumstances, the taxpayer was nothing more than "an unpaid collection agent, like an employer forced to collect his employees' social security taxes for the government." *Illinois Power Co. v. Commissioner, supra* at 690. In reaching its conclusion, the court stated that:

> The underlying principle is that the taxpayer is allowed to exclude from his

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[15] In 1979, the ICC determined that the taxpayer should pay out the special fund money to certain customers, not the same customers who paid the rate resulting in the fund, through a monthly credit against their gas bills.

> income money received under an *unequivocal* contractual, statutory, or regulatory duty to repay it, so that he really is just the custodian of the money. * * * [Emphasis added.]

Illinois Power Co. v. Commissioner, supra at 689.

In the instant case, however, CINB held the excess interest under a claim of right and it was not under an *unequivocal* contractual, statutory, or regulatory duty to repay the amount thereof to CAP Loan borrowers. This, coupled with the fact that CINB's use and disposition of the excess interest was unrestricted except for the financial and regulatory requirement that sufficient overall assets be maintained to meet its liabilities,[16] mandates application of the claim of right doctrine. The Seventh Circuit pointed out the distinction on which we think this issue turns:

> Where, unlike the case of a trustee or a collection agent or a borrower, the taxpayer's obligation to refund or rebate or otherwise repay money that he has received is contingent, the money is taxable as income to him. * * * [Citations omitted.]

Illinois Power Co. v. Commissioner, supra at 689.

Petitioner asserts that "there was very little likelihood high floating interest rates in the late 1970's would drop precipitously below CAP rates established in the early 1970's." Petitioner also asserts that the likelihood of its

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[16] The financial and regulatory requirement that CINB maintain sufficient assets to meet its liabilities, including its contingent repayment obligation, has not been shown to be a restriction on use or disposition different from that imposed with respect to any of CINB's other income or assets.

"highly creditworthy and sophisticated corporate CAP Loan borrowers" prepaying or defaulting, "thereby depriving themselves of the right to receive substantial prior excess interest payments, was extremely remote." Further, petitioner asserts that the likelihood of retaining excess interest in the event of prepayment or default "was rendered even more remote in light of CINB's design and practice to waive forfeiture provisions in order to enhance customer relationships." Based on those assertions, petitioner argues that the probability of repayment of excess interest was so high as to preclude the inclusion of such excess interest in income.

To support its position, petitioner relies upon the following statement:

> In a world without administrative costs the issue whether a receipt that may have to be repaid is income would be elided. The court would merely ask what the (risk-adjusted) present value of the receipt was, given the probability that it might have to be returned to the payor and the terms and conditions under which the recipient could use the money in the meantime, and the tax would be levied on that value. *But this is not the method used; usually the court just asks how likely is repayment, and if the answer is, not very, the receipt is treated as income. Here the likelihood was too great to permit the government to treat the [special fund money] as income.* [Emphasis added.]

Illinois Power Co. v. Commissioner, supra at 690. However, as is apparent from the preceding discussion of *Illinois Power Co.*, the Seventh Circuit did not simply ask

"how likely is repayment." Rather, in determining the taxability of the special fund money that court focused on whether the taxpayer had an unequivocal, as opposed to a contingent, repayment obligation. We think that such a focus is appropriate here.

Each of the parties also argues that its position is supported by *Franklin Life Insurance Co. v. United States*, 399 F.2d 757 (7th Cir. 1968), cert. denied 393 U.S. 1118 (1969). In that case, Franklin Life Insurance Company (Franklin) loaned policy holders amounts against the cash surrender value of their policies. Interest on policy loans was payable in advance. The first payment covered the period between the time of the loan and the end of the policy year; for ensuing years, interest payments were due annually in advance on the policy anniversary date. If interest was not paid when due, Franklin capitalized the interest due by adding it to the principal of the existing loan and charging interest on the increased balance at the same rate.

If during the year a borrower either repaid the loan, or surrendered the policy or the policy matured, Franklin retained only that portion of the prepaid interest which was ratably earned and the remainder was refunded. Franklin reported interest as income when it was earned. Thus, if at the close of its tax year, it had earned only a portion of the prepaid interest on a policy loan, only that amount was reported as income. The Commissioner assessed deficiencies because he considered the prepaid interest to be fully taxable, notwithstanding Franklin's contingent duty to refund.

In *Franklin Life Insurance Co.*, the court relied on the claim of right doctrine as enunciated in *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932), for its legal conclusion that:

> The money is "earned" in a context sufficient for full tax recognition in that taxpayer, when it receives the interest, is fully entitled to it under the express terms of the policy loan agreement. And taxpayer is free to use or invest the full sum in any way it sees fit. * * *

Franklin Life Insurance Co. v. United States, supra at 762. Respondent argues that the facts of the instant case parallel those of *Franklin Life Insurance Co.* so closely that the same rationale ought to apply here. We agree with respondent.

Petitioner argues that, even though Franklin was required to recognize advance payments of interest on policy loans as income, deferral of excess interest which CINB received with respect to CAP Loans is appropriate because of the high probability of repayment. In support of its position, petitioner relies upon the following statement:

> Required use of an accrual method of accounting is not a dispensation from the fundamental precept that the accounting clearly reflect that which by a present right to receipt is "earned", and is subject to the taxpayer's dominion and use, although a possibility of its future return may exist. * * * *Moreover, taxpayer made no showing of its experience with respect to the return of prepaid interest. It did not demonstrate that any significant amount was actually refunded.* * * * [Emphasis added].

Franklin Life Insurance Co. v. United States, supra at 763. We remain unconvinced, however, that a different result would have been reached even if Franklin had shown, as

petitioner has here through the use of hindsight, that a significant amount of interest would actually be refunded to policy loan borrowers in subsequent years. Contrary to petitioner's contention, the relevant inquiry is not whether there is a high probability of repayment but whether the repayment obligation is unequivocal or contingent. *Illinois Power Co. v. Commissioner, supra.*

Although CINB's actual experience reveals that there was a high probability of repayment, it also reveals that there was no certainty as to the repayment of excess interest to CAP Loan borrowers. Cf. *Brown v. Helvering*, 291 U.S. 193, 201 (1934). Thus, petitioner misplaces its reliance on *Illinois Power Co. v. Commissioner, supra,* and *Franklin Life Insurance Co. v. United States, supra,* because those cases were not decided on the basis of repayment probabilities. The Court of Appeals for the Seventh Circuit merely suggested in dicta that a method which takes account of such probabilities might be an "analytically sounder but administratively less feasible method * * *." *Illinois Power Co. v. Commissioner, supra* at 690.

Deposit or Advance Payment of Income

Petitioner argues next that, in substance, the excess interest payments which CINB received from CAP Loan borrowers were nontaxable deposits. First, petitioner analogizes excess interest to regular bank deposits, emphasizing that both were recorded on its books as liabilities and subject to a contractual repayment obligation. Second, petitioner relies upon those cases such as *Indianapolis Power & Light Co. v. Commissioner*, 857 F.2d 1162 (7th Cir. 1988), affg. 88 T.C. 964 (1987), cert. granted __ U.S. __, 109 S.Ct. 1929 (April 24, 1989), which distinguish between security deposits and advance payments of income. Even assuming, arguendo, that the conceptual

difficulties encountered in treating excess interest (i.e., portions of particular periodic interest payments) as deposits could be overcome, we reject petitioner's deposit argument as being without merit. As the Supreme Court reiterated in another context in *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974):

> This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not. * * * [Citations omitted.]

Petitioner's claim that excess interest, in effect, constituted deposits by CAP Loan borrowers comparable to those of other depositors is unfounded. CINB paid no interest on excess interest while interest was presumably paid on regular deposits, and the contractual repayment obligation with respect to excess interest was contingent while it was definite with respect to regular deposits. Under such circumstances, we refuse to convert the debtor-creditor relationships established by CAP Loan agreements into relationships of depositors and holder of deposits merely to satisfy petitioner's desire that excess interest be treated as nontaxable deposits for Federal income tax purposes.

We are similarly unimpressed by the support which petitioner attempts to glean from *Indianapolis Power & Light Co. v. Commissioner, supra*. That case sets forth criteria, albeit different criteria from that set forth in *City Gas Co. of Florida v. Commissioner*, 689 F.2d 943 (11th Cir. 1982),

revg. 74 T.C. 386 (1980).[17] to be used for distinguishing deposits from advance payments, which must generally be included in gross income upon receipt regardless of the recipient's method of accounting for tax purposes. In affirming our decision, the Seventh Circuit held that the proper approach is to determine through an analysis of the facts and circumstances "whether the principal purpose of a 'deposit' is to secure future performance or to serve as an advance payment of income." *Indianapolis Power & Light Co. v. Commissioner, supra* at 1170. (Fn. ref. omitted.) In that case, we determined the taxability of customer deposits by evaluating the rights retained by customers and the rights acquired by the utility company which held such deposits. *Indianapolis Power & Light Co. v. Commissioner,* 88 T.C. at 976-978. In this case, petitioner contends that the rights which CAP Loan borrowers retained in the excess interest were so substantial as to render such excess interest nontaxable. We do not agree.

Unlike the depositors in *Indianapolis Power & Light Co.*, CAP Loan borrowers did not control the ultimate disposition of excess interest. *Indianapolis Power & Light Co. v. Commissioner*, 88 T.C. at 977. Dispositions of excess interest depended in part upon interest rates because CINB was entitled under CAP Loan agreements to use excess

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[17] Because this case is appealable to the Seventh Circuit, we determine the merit of petitioner's argument under the criteria which that court uses to distinguish deposits from advance payments. We do not, however, think that the result would be any different under the Eleventh Circuit's *City Gas* test. The Supreme Court will have an opportunity to reconcile the split of authority in this area when it reviews *Indianapolis Power & Light Co. v. Commissioner*, 857 F.2d 1162 (7th Cir. 1988), affg. 88 T.C. 964 (1987), cert. granted __ U.S. __, 109 S.Ct. 1929 (April 24, 1989).

interest to cover shortfalls. Moreover, the availability of excess interest to cover shortfalls convinces us that it was more in the nature of an advance payment than a deposit. Another factor which indicates that excess interest was not intended as a deposit, and which the Seventh Circuit considers to be "very important," *Indianapolis Power & Light Co. v. Commissioner, supra* at 1170 n.12, is the fact that CINB paid no interest on excess interest. *Indianapolis Power & Light Co. v. Commissioner*, 88 T.C. at 978. Thus, contrary to petitioner's contentions, the rights to excess interest were significantly different from those of depositors and a holder of deposits.

Advance Payment of Income

Finally, petitioner attempts to distinguish this case from a trilogy of Supreme Court cases, *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957), *American Automobile Association v. United States*, 367 U.S. 687 (1961), and *Schlude v. Commissioner*, 372 U.S. 128 (1963), upon which respondent relied in part when he determined that excess interest was required to be included in income. Those cases stand for the proposition that deferral of prepaid income by an accrual basis taxpayer is not generally permissible for income tax accounting purposes. According to petitioner, however, current recognition of prepaid income is limited under those cases to situations where the recipient is entitled to such income regardless of future events. Thus, petitioner argues that CINB's contingent repayment obligation precludes recognition of excess interest for the years in issue. We reject petitioner's argument because the Supreme Court did not limit the general rule against the deferral of prepaid income in the manner suggested by petitioner. Nor has petitioner shown that those cases do not otherwise apply with respect to excess interest.

The narrow exception carved out by the Seventh Circuit in *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968), revg. and remanding 48 T.C. 411 (1967), is inapplicable under the circumstances presented here. In that case, a baseball team reported receipts from advance ticket sales as income only if the games to which such receipts related were scheduled to be played during the taxable year. Receipts which related to games scheduled for the succeeding taxable year were deferred. Relying primarily upon the trilogy of Supreme Court cases, we held that receipts from advance ticket sales were includable in income when received. The Seventh Circuit reversed, holding that those cases which we relied upon did not establish a per se rule against deferral of prepaid income. *Artnell Co. v. Commissioner, supra* at 985. That court concluded that the Supreme Court objected primarily to the uncertainty regarding when prepaid income would be reported and it distinguished the trilogy of cases on that basis. In that connection, the court stated:

> The uncertainty stressed in those decisions is not present here. The deferred income was allocable to games which were to be played on a fixed schedule. Except for rain dates, there was certainty. We would have no difficulty distinguishing the instant case in this respect.

Artnell Co. v. Commissioner, supra at 984.

In *Artnell,* the fixed schedule of dates on which baseball games were to be played effectively eliminated uncertainty regarding when income from advance ticket sales would be reported. In the instant case, however, uncertainty remained with respect to excess interest because CINB's contingent repayment obligation depended upon interest rate

volatility and whims of CAP Loan borrowers. Such uncertainty renders the exception carved out in *Artnell* inapplicable.

Petitioner also argues that certain other exceptions support its position with respect to excess interest. Although Rev. Proc. 71-21, 1971-2 C.B. 549, provides an exception to the general rule that income cannot be deferred beyond the year of receipt, its scope is quite narrow and, contrary to petitioner's contention, we find no application for it here. Moreover, respondent's revenue procedure is not substantive law; it merely sets forth guidelines representing the position taken by respondent under circumstances not present here. *Virginia Education Fund v. Commissioner*, 85 T.C. 743, 751 (1985), affd. 799 F.2d 903 (4th Cir. 1986). By its own terms,[18] Rev. Proc. 71-21 applies strictly to advance payments made pursuant to contracts for the performance of future services. CAP Loan agreements were not contracts which dealt with the performance of future services. Rather, those contracts established the debtor-creditor relationships which existed between CINB and CAP Loan borrowers. Similarly, excess interest payments do not constitute advance payments within the meaning of section 1.451-5, Income Tax Regs., and therefore that section affords no relief from the

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[18] That procedure was promulgated:

> to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for Federal income tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year.

Rev. Proc. 71-21, 1971-2 C.B. 549.

general rule regarding the inclusion of advance payments in income.

Lastly, petitioner argues that respondent's position in this case conflicts with the position set forth in Notice 89-21, 1989-8 I.R.B. 23, regarding the tax treatment of lump-sum payments received in connection with "notional principal contracts." Without commenting upon the validity of the position taken in Notice 89-21, we reject petitioner's argument because this case deals with neither lump-sum payments nor "notional principal contracts." Moreover, Notice 89-21 is merely an administrative pronouncement, like a revenue ruling or revenue procedure, which does not constitute authority for deciding a case in this Court. Cf. *Follender v. Commissioner*, 89 T.C. 943, 958 (1987); *Virginia Education Fund v. Commissioner, supra; Neuhoff v. Commissioner*, 75 T.C. 36, 46 (1980), affd. 669 F.2d 291 (5th Cir. 1982). Thus, we deem further discussion of Notice 89-21 and the argument which petitioner made in that connection to be unnecessary.

Based on the foregoing, we hold that respondent did not abuse his discretion when he determined that CINB's method of reporting interest income with respect to CAP Loans did not clearly reflect income. Accordingly, for the years in issue interest income must be accrued on CAP Loans at the floating rate and in the year when interest payments at that rate were due and payable, or paid, whichever was earlier.

Respondent also determined that pursuant to section 481, which relates to adjustments required by changes in accounting method, the $16,371,168 balance in CINB's "Interest Collected But Not Earned" account as of January 1, 1977, was required to be included in petitioner's gross income for that year. Petitioner has shown no facts nor

made any argument or statement with respect to the application of section 481. There are no facts in the record tending to show that respondent applied that section incorrectly. Therefore, we hold that the adjustment which respondent determined to be necessary under section 481 is required to be made to petitioner's income for the year 1977.

Decision will be entered upon disposition of remaining issues.

APPENDIX C

26 U.S.C. § 61 (1976)

SEC. 61. GROSS INCOME DEFINED

(a) GENERAL DEFINITION. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

* * * * *